

TO: Files

CC: Audit Committee

FROM: Willkie Farr & Gallagher

RE: Interview of Dennis Kahlie, October 18, 2005

DATED: October 26, 2005

On October 18, 2005, Michael Schachter and Sharon Blaskey interviewed Dennis Kahlie on behalf of the Audit Committee. Mr. Kahlie was represented by counsel, Eugene Iredale. Also in attendance were Omid Yazdi and Thomas Wang of KPMG, and intermittently, Troy Dahlberg on behalf of the Audit Committee. The interview took place at the offices of Eugene Iredale and lasted a full day.

The following memorandum reflects my thoughts, impressions and opinions regarding our meeting with Dennis Kahlie, and constitutes protected work product. It is not nor is it intended to be a transcript of the interview.

At the outset of the interview, Mr. Iredale requested an opportunity to review and correct the notes summarizing Mr. Kahlie's interview. Mr. Schachter informed Mr. Iredale that the notes constituted work product and therefore Mr. Kahlie would not have an opportunity to review them, in part to protect that work product. Mr. Schachter also stated that the notes were not intended to be a transcript of the interview but rather our own record and understanding of the interview, including our mental impressions, and that the statement we create would not be one adopted by Mr. Kahlie. Dahlberg also commented that we do not want our investigation compromised in any way by having others read and comment on the way the memo was done. He also stated that as part of the Committee's task of working expeditiously, we are not separating our work product from the other portions of the memo.

Warnings

Mr. Schachter began the interview by describing the circumstances and purpose of the City of San Diego's (the "City") creation of an Audit Committee, explaining the Committee's goal to conduct a thorough and independent investigation into various disclosure issues in order to give KPMG and others confidence in the City's financial reporting system moving forward. He stated that the Committee would create a report, which KPMG or governmental agencies could use in connection with their own work, and Mr. Schachter therefore stressed the importance of Mr. Kahlie's accurate and truthful testimony. Mr. Schachter asked Mr. Kahlie whether he had any questions before proceeding, and he stated that he did not. Mr. Schachter further explained that Willkie represents the Audit Committee of the City and not Mr. Kahlie personally. He stated that the interview was not a privileged communication, though we do ask that he keep it confidential.

Background

Mr. Kahlie started working for the City in 1975. He began doing administrative analytical work for the fire department, which he did for two years before switching to the financial management department. He was in that department for about one year working on productivity-related issues until he switched to the water utilities department and started as an assistant rate analyst. From there he became a rate analyst and proceeded to work within the water utilities department for about 18 years doing rate analysis work. At some point there was a reorganization within the water utilities department that separated out the rate analysis function from the utilities department. Six or so years ago, the rate analysis function transferred again, this time to the City Manager's Office, as a part of what is now known as "Financing Services." Financing Services now falls under the City Treasurer's Office, and this is Mr. Kahlie's current group. At that time, he was promoted from analyst to supervisor. He now serves as the Utilities Finance Administrator for the City, and his responsibilities include supervising rate analysts for both the water and wastewater departments. In that role, he has supervised a number of Cost of Service Studies ("COSS") concerning both water and wastewater, and has supervised the process of preparing bond offerings for water and wastewater, which is a responsibility he adopted in about 1998.

Generically speaking, a "rate analyst" evaluates data, including revenues, expenditures, the relationship between the two, whether revenues are sufficient to offset expenditures, and if not, what needs to be done to increase revenues to offset expenditures. Rate analysts also look at "who" to get money from when a decision is made that a certain amount of funds is needed. That analysis, in part, focuses on where in the customer base the revenue is generated.

Mr. Kahlie described that a COSS involves determining the origin of costs in providing a service such as, for example, water or wastewater. The study then focuses on segregating costs into cost centers, and, typically, it will also include a rate design function. Mr. Kahlie described that a COSS concerns two fundamental issues: (1) how much money you need, and (2) how you generate the funds necessary to meet those financial obligations over time. There is no mandated frequency for the City to conduct a COSS, and one would typically be done if there were some concern about how costs were being allocated among user classes. One common example of when a study would be done is if there were a concern that "one person were getting a better deal than another," or if there were a material change in "the cost centers that were driving your expenditures." It would then make sense to examine how costs were spread among ratepayers to make sure the right people were getting charged.

Regarding Mr. Kahlie's role in bond offerings beginning in about 1998, he described that as part of an offering, a financing team is put together, including auditors, bond disclosure counsel, and others, to do the offering. For water and wastewater offerings, there would typically be a senior staff person assigned to "shepherd the offering along."

When Mr. Kahlie was a rate analyst (until he became a supervisor in 1998 or 1999), he was responsible for both water and wastewater since then, unlike now, the two were a one-person job. For example, in 1991 he was the only rate analyst for both water and wastewater. He believes he was reporting to Steve Hogan at that time. At some subsequent

point the water utilities department broke into two departments, the water department and the metropolitan wastewater department ("MWWD"). It was at that time that the rate analysis function became separate from both of those departments, as described above. He believes that Hogan was in charge of rate analysis at that time.

Wastewater Issues

Mr. Kahlie was shown Exhibit 1, a July 19, 1989 letter from Rod Rippel to Frank Peters, cc: Mr. Kahlie and others (DK 03938). Since the letterhead says "water utilities department," Mr. Kahlie thinks that in all likelihood he was then a rate analyst in the water utilities department reporting to Hogan. Rod Rippel, who is the author of Exhibit 1, was the City's Industrial Waste Program Manager, which included responsibility for running the City's industrial waste permits. Rippel managed other requirements of the grants as well, one of which was the requirement to establish an industrial waste program to monitor the dischargers who, pursuant to the Clean Water Act ("CWA"), must be monitored. Mr. Kahlie recalls the circumstances of Exhibit 1 were that the City was attempting to come into compliance with the SWRCB's requirements of having an approvable rate structure in a primary treatment environment. To do that, not just the City, but also each of the Participating Agencies ("PA's"), had to have an approved compliant rate structure. He recalls that at this time they were in the process of meeting regularly as a group with agency heads of each of the PA's. Explaining his statement that the City's objective was to become compliant in a primary treatment environment, Mr. Kahlie stated that in a primary treatment environment the rate structure had to consider flow and total suspended solids ("TSS"). However, Mr. Kahlie said that, "we knew that as we progressed toward the construction and completion of secondary treatment plants" (he recalled the North City Plant was then anticipated), then with plants with secondary and tertiary abilities, "there would be a requirement to consider a third cost center, organics." Mr. Kahlie recalls that at the time of this letter, the state board guidelines only referenced "BOD" in terms of an acceptable organics component. In order to prepare for the transition to the inclusion of an organics component "in a way that was most efficient for those who would have to accomplish it at the technical level," the City suggested using an alternative measure for organics, COD, which, compared to BOD, could be accomplished with a lot less effort, cost, and time. BOD is also called BOD-5 because it requires pulling samples and then taking 5 days to determine the organics content of those samples. Mr. Kahlie explained that when organics decompose they consume oxygen. So when organics are put into the water they "suck up a lot of oxygen and the sea life dies," which is why you want to remove organic materials, in order to reduce the absorption of oxygen as part of the decomposition of organic material. Mr. Kahlie cautioned that with that said, the City argued successfully a few years back that in a plant with a deep ocean outpour, such as Point Loma, secondary treatment is overkill. At that time the City argued that there was no scientific evidence of any adverse or positive impact on the ocean environment from the dumping of organic materials.

Regarding Exhibit 1, Mr. Kahlie described that the City was proposing that if or when it would use an organics measurement, it wanted to use COD instead of BOD. Mr. Kahlie went into a detailed description of a primary treatment environment, which, by design, is not intended specifically to remove organics, just suspended solids. He explained that organic material can be suspended or dissolved. An example of "dissolved" material is sugar, which disappears rather than floating. He contrasted sugar to grass, which is organic but would float.

Dissolved materials do not get removed in primary treatment environments, and additional filtration and chemicals would be needed to get those types of materials out. As of the time of Exhibit 1, Point Loma was the only treatment plant on-line. At some point around then, Point Loma became an advanced primary plant. The permit that the City had for the operation of Point Loma (the "NPDES" or "National Pollution Discharge Elimination System" permit) contains certain requirements. Mr. Kahlie does not know when, but at some point a BOD/COD requirement was incorporated as one of those requirements into Point Loma's NPDES permit.

In connection with his job responsibilities in 1989, Mr. Kahlie said he had contact with Frank Peters, who Mr. Kahlie identified as the staff person assigned to monitoring compliance with the State board requirements regarding rate structure, revenue plan submissions, and other issues. Mr. Kahlie described the history of the State's grant and loan program. He said that with the adoption of the CWA, a grant program was established by the Environmental Protection Agency ("EPA"). The government would give grants to cities to do things like upgrade their plants to meet CWA requirements. The EPA chose to act through State agencies for purposes of administering the requirements of the CWA with respect to the grant program. Within California, the State Water Resources Control Board ("SWRCB") was designated by the EPA to administer the grant program and its requirements. Cities would then apply to the SWRCB for Clean Water Grants ("CWG"). The CWG program later lapsed and was replaced with the State revolving fund ("SRF") loan program in about the mid-1990's. In response to why the State is interested in how cities charge rates, Mr. Kahlie responded that the CWA requires that the cost of utilizing grant or loan-funded infrastructure be apportioned amongst users on "a basis proportionate to use." He describes this requirement as "getting at a proportionate allocation of cost," and he understands its objective to be identifying the costs of removing what needs to be removed and to allocate those costs proportionately to those people who cause those things to be there in the first place.

Exhibit 2 (DK 03940), a 7/28/89 memo from Rippel to Mr. Kahlie, describes a conversation Rippel had with Frank Peters in which Peters said it was ok to use COD instead of BOD. In this timeframe the City was anticipating that North City would come online in the mid-90's, but COD was being contemplated as of 1989 because it was clear that "we were moving in that direction." Mr. Kahlie recalled that at around that time, the government wanted everyone to utilize secondary treatment, and the City was resisting that. The City had applied for a 301(h) waiver which, if granted, would exempt the City from the secondary treatment requirement. Mr. Kahlie said that the EPA resisted granting the City the waiver and that the City was "instrumental" in amending the CWA with regard to the 301(h) waiver, which waiver is good for 5 years and is renewable. At that time the deadline had passed for the City to convert to secondary treatment, but because the City had applied for a waiver from that requirement and the decision was pending, the City was not getting sued. However, in 1987, the City withdrew its waiver request in light of then-Mayor O'Connor's view that doing so would get the City federal funding. Upon withdrawal of the permit, however, the federal government sued the City, which suit was followed by protracted negotiations about whether there was a need in the City for secondary treatment. The Court ultimately agreed with the City's experts that said that there would not be an adverse impact on the environment from not having a secondary treatment facility. That said, according to Mr. Kahlie, the environment of the time was that the City knew the likelihood was that it would be moving to secondary treatment, and Exhibits 1 and 2 reflect that they were "trying to iron out the administrative wrinkles."

Exhibit 3 (EA 02435) is a March 30, 1990 "Wastewater Rate Study and Financial Plan and Revenue Program." Mr. Kahlie said that this is an example of a portion of the document that was submitted to the State in 1990 and is what he refers to as "the March '90 rate case." He said it was submitted to the State as part of the approval process for a revenue plan, which was the plan approved by the State. This plan says that the City will measure flow and SS, but it does not say the City will measure organics. In general, as part of the process of getting State approval of the plan, the City must do an analysis that produces a proposed rate structure, which analysis is submitted to the State board staffer for review. If the staffer agrees that the analysis is appropriate he will grant approval and the plan should then be implemented.

Exhibit 4 (DK 3941) is a letter dated September 18, 1991, from Ron Blair to Charles Yackly, discussing approval of the revenue plan. According to Mr. Kahlie, as of this time, the PA's used Point Loma but submitted their own revenue programs. The City provided transportation, treatment and disposal services to PA's, but it was the PA's own responsibility to provide "collection" services to move that flow to a point of connection with the City's system. These so-called "metro-related costs" (for those services that the City provides to the PA's) constitute one of several cost centers for each of the PA's. To that cost, the PA's add their own costs (i.e., for collection services). Mr. Kahlie thinks the City would send a bill to each PA under contract with the City. As of the time of this letter (Exhibit 4), the City was only charging the PA's based on flow and volume. The staff in the wastewater department (not Mr. Kahlie) administered the allocation of costs to PA's. Mr. Kahlie did not see the bills from the City to the PA's and said that he did not have a role in discussing PA billing with supervisors. He does not think, however, that the PA's would have had a reason to allocate costs based on organics to their own users at this time, since the City's own bills to the PA's did not allocate costs to organics. He thinks the wastewater department would have applied industry standards to calculating charges to the PA's, including estimating where the volumes came from and apportioning the costs accordingly.

Mr. Kahlie was then shown Exhibit 5 (DK 5453-54), a September 30, 1994 letter from Blair to Jack McGrory, directing, among other things, that the City "must modify their agreements with all participating agencies to include charges for BOD and TSS content as well as flow discharged into City facilities." Mr. Kahlie thinks he has seen the letter. With regard to Exhibit 6 (DK 2306-08), he believes he has seen a portion of it, DK 2308 (an August 9, 1994 letter from Blair to McGrory informing the City that it has been selected by the State for an on-site review of its revenue program, and its sewer use and rate ordinances), but does not recall seeing DK 2306-07 (memos from Hogan to Gammon dated September 12, 1994). Of Blair's visit to the City in 1994, Mr. Kahlie said he "had no involvement." He does not recall whether he was aware of the visit at the time it took place. He does not know when he learned that Blair told the City that it had to include COD for the PA's, but he thinks it was around 1994. He may have learned of these 1994 interactions from Bill Hanley, the Deputy Director of the MWW. Mr. Kahlie discussed that, at some point, the PA's came to realize that rates based on flow and volume alone were not in their best interests. He characterized the relationship between the City and the PA's as one of "wariness" on the part of the PA's. The PA's realized that if costs were allocated among solids and organic loads, in all likelihood their bills would be lower, because for the most part they did not have industries in their communities. He thinks he learned from Hanley that some PA's approached Blair and told Blair that they were only being billed on flow. Mr. Kahlie heard that the PA's told Blair that they thought their charges should also include an

organics component, which precipitated some interaction between the City and Blair. Mr. Kahlie thinks that in 1994 North City was not online yet, but that there had been a change to the Point Loma permit requirements that incorporated an organics requirement. Mr. Kahlie suggested that Alan Langworthy (former MWWDD Director in Charge of Lab Facilities) would be the person to speak with about the permit requirements. Mr. Kahlie said that Hedy Griffiths would have been the person on behalf of the MWWDD to interact with the PA's and to supervise the billing function and contracts. Mr. Kahlie's job, however, did not relate to the City's contracts with the PA's.

According to Mr. Kahlie, Exhibit 7 (DK 5455), which is a handwritten memo with "Exit Interview" written at the top, does not appear to be his handwriting and he does not think he recognizes it. Exhibit 8 (DK2266-76) is a May 9, 1995 letter to Blair from Schlesinger, reporting on the City's progress in response to Exhibit 5, Blair's letter to the City demanding that the PA's be charged with an organics component. Exhibit 9 (DK 2292-93) is a June 9, 1995 letter from Blair to Schlesinger in which Blair states, "In general, I did not find anything in your proposals that would violate Clean Water Grant program regulations or guidelines." Mr. Kahlie has seen Exhibits 8 and 9, and thinks the handwritten note on Exhibit 9 stating, "Note that 9/91 revenue plan approval was conditional" is probably his. He does not know when his handwritten note was added, nor does he recall why it was added. The note probably means that the 1991 approval letter contains a reference to the fact that the revenue plan is subject to periodic reviews. He is familiar with the subject matter of Exhibits 8 and 9 but does not know whether he read them back in 1995. He believes the documents were a follow-on to the PA issue. He recalls discussing that the requirement to include an organics component for the PA's had to do with changes in the Point Loma permit. His understanding of Exhibit 8 is that the City is telling Blair how the City is proposing to transition to strength-based billing for the PA's. Mr. Kahlie understands that the PA agreements were being generally revised in this timeframe. The objective in revising the agreements was to create new 50-year agreements, to move forward with the PA's while recognizing that construction was planned for which costs could be recovered from the PA's. The second negotiation in connection with the PA contract renewal was related to the issue of how PA's would be billed. In 1995, Mr. Kahlie had no role in negotiating the change with the PA's, and he does not think he reviewed these letters back in 1995.

Looking ahead to Exhibit 10 (Eric Adachi 7CAB MS7B, Sewer Cost of Service Box 1 Folder "D" 0001), an email dated Nov 13, 2002 from Mr. Kahlie to Ryan, Loveland, Salt, Vattimo, Frazier and Mendes, re: "Revision #2 to Sewer COS Briefing Document," with an attachment entitled "Salient Points," Mr. Kahlie described the attachment as an "outline." At pages 2-3 of the attachment there is a reference to the State having been under the "mistaken impression that the PA billing structure it had approved was applicable to the City's municipal users as well." In response to a series of questions regarding how Mr. Kahlie came to understand that the State was under a "mistaken impression" of the City's allocation of costs for retail users, and to what extent that mistaken impression was something that was discussed among people back in 1995, Mr. Kahlie responded that the preceding exhibits (8 & 9) relate to the effort on the part of the City to satisfy Blair with a compliant rate structure for PA's. Compliance was accomplished by means of an amendment to the PA's 50 year agreements, and Mr. Kahlie recalls having seen a letter from Blair to the City indicating that Blair was satisfied with that. So at that juncture, the rate structure was compliant "insofar as it related to the mechanism by which the

City billed the PA's." With respect to a "mistaken impression," Blair believed (as he related to Mr. Kahlie sometime later), that the change to the PA rate structure was also applicable to retail customers within the City. Mr. Kahlie thinks he learned that Blair had that misimpression during a phone conversation between the two at some point in 1998 in connection with the then-on going COSS.

Mr. Kahlie said that, today, he did not know of any efforts to change the retail rate structure to include organics back in 1995. In response to why there would not have been that effort (wouldn't the State's letters have indicated to the City that the State would view the City's rate structure as being out of compliance?), Mr. Kahlie responded that, from his own point of view, he would have concluded that the City was not in compliance. Mr. Iredale pointed out, however, that Mr. Kahlie's answer is only from the vantage of looking back in time. In response to what Mr. Kahlie's own view in 1995 was of the City's compliance, Mr. Kahlie said that by that point, North City would have come online, so permit issues notwithstanding, if the City were running a secondary treatment facility, organics would need to be considered. Mr. Kahlie said that, "clearly that was not happening at the retail level," and he is "sure" he had conversations with people about that. He thinks Dave Schlesinger was aware, and that he may also have told McGrory. In response to why, if Mr. Kahlie's understanding was that the system was non-compliant, the rate structure was not changed, Mr. Kahlie opined that it was probably because the State "wasn't pressing." Mr. Kahlie said he had "always been in favor of a compliant rate structure." Since early in his career he was assigned to work on one of the first COSS's, and thereafter he always seemed to get tasked with them. Back in 1995, in theory it would have been Council's decision as to whether to change the rate structure, but at that time there would not have been the impetus to even bring the issue to Council. Mr. Kahlie said (and repeated several times throughout the interview) that while he could say the system was not compliant, nevertheless, since no one was "belly-aching" about it, then he would be told that the issue was not ripe to address. While he does recall making the point that the system was out of compliance, he does not recall who would have given him that response as of that point in time. Mr. Kahlie described that the City's adoption of the change for the PA's was a result of an "external force" (specifically, the State telling the City to make a change), and the City complied with the request of the State "with precision." He elaborated that the State board staff mistakenly assumed that the City's response "extended further than it did," so therefore the State made no demands.

Besides Mr. Kahlie himself, Mr. Kahlie believed that the others who knew in 1995 that the rate structure was non-compliant included senior members of the wastewater department, Schlesinger (whom Mr. Kahlie recalls telling but does not recall his response), and probably Jack McGrory (though that is pure speculation). He thinks McGrory would have known because Schlesinger, in describing the change being made to the PA agreements to McGrory, would probably need to describe the scope of those changes for McGrory to present the issue to Council for approval. He does not specifically recall if anyone expressed the view that "if no one was belly-aching" then the City would not make the change. Regarding Exhibit 8, the 1995 correspondence to the State, which Mr. Kahlie characterized as a "precise" response, Mr. Kahlie said he was not involved in the decision to give a "precise" response, and he does not know whose decision it was. Mr. Kahlie said the transaction was handled solely in MWW by Hedy Griffiths, Bill Hanley and Schlesinger.

Mr. Kahlie was then shown Exhibit 11 (DK 02314), a February 13, 1997 memo to the Mayor and City Council, regarding the City of San Diego v. City of Coronado. Mr. Kahlie did not recall the document. Next he was shown Exhibit 12 (COS 002099), an email from Hedy Griffiths to various distribution lists, dated 03/14/97. Mr. Kahlie said that Corrinne Smith is the individual who is in charge of sewer classification in the water department, and he believes she is currently a City employee. "Sewer classifications" are analyses done for billing purposes, and they relate to a user's discharge. Classifications are assigned but may change over time. The email references a meeting with Mr. Kahlie and Moffett, a rate analyst who joined Financing Services in 1997 or 1998 (around the same time as Mr. Kahlie), who was handling sewer rates at that time. Mr. Kahlie was primarily working on water related issues at that time, in addition to providing oversight of Moffett, but he thinks he would have been at the meeting referenced because he had the historical knowledge. The "Jerry" referenced in the email is probably Jerry Alesi. He has no particular recollection of the meeting. The word "CIS" in the email is referring to the mainframe billing system used for water and wastewater. Mr. Kahlie recalls planning for adding a COD component and that the hope was to have it implemented by July 1997. The people involved in the planning aspects included representatives from San Diego Data Processing Corp, people like Alesi, and maybe Corinne Smith. Mr. Kahlie thinks the purpose of this meeting would have been to discuss mechanical issues. Since the CIS system was put into place in the late 1970's/early 1980's (and is still in use today, through periodic modifications), it would not have been designed to handle a multiplicity of billing factors. As of this time in 1997, Mr. Kahlie recalls that the City had begun what was ultimately the 1998 COSS by Pinnacle One. He knew then that if the study were adopted, then the system would have to be modified to handle a three component billing structure. The meetings that took place were to try to figure out how that could be accomplished (from a technical and programming perspective).

Exhibit 13 (DK 10112) is a set of handwritten notes, dated 4/9/97. Mr. Kahlie thinks it looks like his handwriting and that it must be notes he took on a variety of subjects at a meeting. Focusing on the bottom of page 1 to the top of page 2, there is a reference to the water COSS and there also appears to be a reference to sewage, but he does not recall this particular meeting. Regarding the statement under III.D that "agreement that evidence of action leading to compliance with rates..." Mr. Kahlie does not know what that is a reference to or who attended that meeting. Exhibit 14 (MWWD- BH0943) is a memo dated April 25, 1997 to the MWWD Director from Mr. Kahlie. The memo describes the COSS "currently being performed by the firm of High-Point Rendel." Mr. Kahlie does not recall the impetus for undertaking this COSS.

Exhibit 15 is a document with "Attachment 7" as the title at the top (no bates). This document appears to be related to a bond offering from 1997. Mr. Kahlie was not familiar with the document but thinks he does have a copy of the 1997 sewer revenue bond in his files. The first bond offering he was involved in was the 1998 water bond offering. Next Mr. Kahlie was shown Exhibit 16 (DK 5456), a letter dated August 18, 1997 from Mick Gammon to Farouk Ismail of the SWRCB, regarding the SRF loan program. Mr. Kahlie said he was "not particularly familiar with" the letter.

Exhibit 17 (MWWD-BH0950) was the May 14, 1998 Pinnacle Study. He said he was "familiar" with it and that it does say that costs have to be allocated by taking into account organics. When the study was completed in May 1998, Mr. Kahlie said it went to a number of people including department heads, the Deputy City Manager, and maybe the City Manager and

Assistant City Manager. He said the report was not implemented, and the one word answer for why it was not, was "Kelco." Mr. Kahlie followed up his answer by stating that, "You'll see that a number of these studies were done and not implemented." According to Mr. Kahlie, the reason they were not implemented is that the inclusion of an organics component into the rate structure *shifts a significant financial burden, particularly on large volume organics dischargers*. One such high discharger was Kelco/ISP Alginates, who regularly opposed the imposition of an organics parameter on a number of grounds, primarily the cost to them. Kelco/ISP have been one or two firms, and currently they are two but reside on the same plot of ground. They are processors of kelp products, or make products that use algin as a base, which means that their waste discharges are extremely high in organics and very low in suspended solids. And even more problematically, their discharge consists of dissolved organics.

As Mr. Kahlie recalls, it was Coleman Conrad's decision not to implement the 1998 COSS. When the COSS was done, it was discussed at a meeting that he, Kelly Salt, George Loveland (the Deputy City Manager overseeing water and wastewater), and Conrad (another Deputy City Manager) attended. At that meeting, the participants discussed the impact of implementing the study, and there was a concern expressed about the impact on Kelco. Mr. Kahlie described that Kelco had always been an issue, and that they were heavy lobbyists, "to the point of being obnoxious and untruthful." As he recalls, Conrad reached the decision that the study would be "put on a shelf," and he recalls that it was both Conrad and Loveland who expressed concern about Kelco. He said that there were always people aware that studies were done, including stakeholders and the State board staff. Mr. Kahlie supervised the studies and he either created the scope of the work or directed the study under his supervision. He was careful to structure studies in a way that ensured they would satisfy State board staff. He did that because studies are expensive and he thought it did not make sense to spend thousands of dollars to do a study only potentially to get an end result that the State would not approve. The other aspect he considered was that the City had a contractual obligation to the State to produce a compliant structure. Therefore he structured each study with the consultant to include a requirement that the study be done in a manner that ensured it would be satisfactory to the State board. Mr. Kahlie recalls that Conrad's explanation for why the study would not be implemented was because of the huge impact on Kelco. Mr. Kahlie contextualized this statement by explaining that at the same time the study was done, Kelco would have been lobbying Council, the Mayor, senior management, and the "big players" at the Chamber of Commerce ("Chamber"). Over the years Mr. Kahlie met with the Chamber on numerous occasions and he believes at least four people on the Chamber had a "very strong bias for Kelco." He elaborated that the Chamber people also lobby politicians. In this context, he thinks it was "understandable" that the City Manager would be told by elected officials not to pursue this course of action (though he clarified that he does not recall anyone referring to elected officials at this meeting). Nevertheless, it was "clear" to Mr. Kahlie that Conrad decided not to implement the study based upon the adverse impact on Kelco and other high organics dischargers.

Exhibit 18 (COS 003348) is an undated memo entitled "City of San Diego Water Cost Of Service Study with a handwritten note at the top stating, "from Mr. Kahlie 8/12/98." At COS 003350 the last sentence of the last bullet states, "Our willingness to accede to their wishes in this regard will mitigate to some degree the impact of including the EPA-mandated COD component in sewer rates. . ." Mr. Kahlie believes he probably did prepare this document and

confirms that it was his understanding that the COD component was EPA mandated "by extension through the State board." He recalls that in the meeting he described earlier with Conrad regarding the possible COSS, Mr. Kahlie also said words to the effect that the COD component was a requirement. That statement is typically met with the question whether the State is "demanding that we do it now," and the answer is typically, "no, but at some point in time they will." The reaction to that response is then typically that "we'll do it then." Regarding Exhibit 17, he thinks he prepared it in response to a request from someone, maybe Schlesinger. He explained the language quoted above in connection with the interrelationship between billing for water and sewer. The same amount of money must be generated (the process is so-called "revenue neutral"), and it is a question of how you choose to generate the money. You could have a high water base fee (favoring high volume water users such as Kelco). The high base fee, a charge independent of the amount of water actually consumed, would favor high volume users in the same way that the sewer rate increase would harm them. So in effect, Exhibit 17 is proposing to "soften the blow" to high volume users. Mr. Kahlie does not recall who Exhibit 17 was sent to, but thinks it was likely MWWD people. This document does not help place in time the Conrad meeting, which he thinks would have been shortly after completion of the Pinnacle One study.

In the Conrad meeting, he does not recall whether or not he talked about the consequences of not being in compliance but he thinks he may have. He thinks Kelly Salt also voiced an opinion of wordsto the effect that the structure was "not compliant" and should be changed. He does not recall Loveland saying much at the meeting, and he thinks those four were the only participants. While he does not recall exactly how much the 1998 COSS cost, he thinks it was somewhere between \$75,000-\$150,000. He also said that if this COSS had been discussed in closed session, he was not aware of it, and that he does not think he discussed changing the user rate structure at any closed session before the January 29, 2002 closed session. He is not aware of any others who participated in the decision not to implement the 1998 COSS, nor is he aware of the COSS being discussed with any elected officials at that time. He has no specific recollection of Kelco making campaign contributions to any elected officials, though he vaguely recalls recently seeing an article in the paper about David McKinley (one of Kelco's "front men" on this issue) giving the maximum contributions to the campaigns of certain people running for Mayor (either to Murphy or Frye, he thinks). He has not heard of any improper contributions or payments from Kelco to anyone, and no one from Kelco ever offered him anything of value.

In addition to the four people in the meeting described above, Mr. Kahlie thinks that Hanley, Schlesinger and others in the MWWD would have reviewed the 1998 COSS upon its completion. Regarding discussions of whether to tell the State that the City's rate structure was not in compliance with the State's requirements, Mr. Kahlie stated that as part of doing the studies there was significant communication between he, consultants and the State board. He thinks, by the time of this study, Blair had already conveyed to Mr. Kahlie that Blair was under the (inaccurate) assumption that the PA agreement had applied at the retail level. As Mr. Kahlie described the conversation, Blair had "stumbled" on his own to the fact that the PA rate structure did not apply at the retail level, and then he communicated his understanding to Mr. Kahlie that he had been under the impression that the City's PA rate structure applied to retail users too. [NOTE: this is inconsistent with Blair's statements.] As Mr. Kahlie recalls, Blair was happy to hear that it was the City's intent to remedy the situation. Mr. Kahlie was not clear as of the time of this conversation with Blair, when the study was underway, that the study would not be

implemented. In fact, it was Mr. Kahlie's understanding that the study *would* be implemented. To Mr. Kahlie's knowledge, after the meeting with Conrad, no one suggested going back to the State to tell Blair the study would not be done. Mr. Kahlie thinks he may have thought about telling Blair, but he does not think it would have been his place to do that since he was not "the high man on the totem pole" at that time. His boss at that time would probably have been Hogan, and Mr. Kahlie does not recall whether he talked to Hogan about the decision.

Exhibit 19 (DK 8862) is entitled "Required Items for the Wastewater System Preliminary Official Statement (Sorted by Responsible Party)" with a handwritten date of 12/2/98. Mr. Kahlie identified the handwriting as his own. He said the document would have been a list of items that were required to produce a POS for wastewater, probably for the 1999 issuance. The list contained responsible parties for providing the underlying information. Typically, when pulling together materials for offering documents, many people provide component parts, which parts are then assembled by bond and disclosure counsel. Mr. Kahlie said the role that he and his staff had was to get a listing of what documents were required, assign someone to provide that information, and then assure it had been supplied to whomever needed it. He thinks Eric Adachi may have prepared Exhibit 18, as it would have been a subordinate person that tracked what was needed. He supposed it could also have been prepared by Marlene DeRose, the financial adviser in this transaction. The document identifies the party or parties responsible for producing each of the items. The starting point for the 1999 POS would have been the 1997 POS. Updating the material would be a matter of looking to certain individuals who prepared the materials for previous issues. The document (Exhibit 18) then would have been the product of an all-hands meeting, and then it would be provided to bond/disclosure counsel. For this offering, Paul Webber (along with Jenna McGann, his associate) were bond and disclosure counsel. The section in Exhibit 18 referring to "Wastewater System Regulatory Requirements" lists Kelly Salt and Jacquelyn Mittelstadt as the responsible parties.

Mr. Kahlie was then shown Exhibit 20, COS 005874, the March 2, 1999 Official Statement for the Sewer Revenue Bonds. At pages COS 005904-05, the document states that "The City's rate structure has been reviewed by the State Board and no grant funds or costs under grant funded programs have been disallowed based on the nature of the rate structures." In response to whether he recalls how this language got inserted into the offering document, Mr. Kahlie stated that "Webber put it there." Mr. Kahlie said that he had discussions with Webber about that language. He thinks the language would have been the product of an all-hands meeting, but that at the end of the day, "these are Mr. Webber's documents." Mr. Kahlie described Webber as "loathe to change anything" that he did not believe to be factually correct. He elaborated that there was "Paul's way," and if you were to tell him that something did not read well, Webber would "get his back in the air about it." Concerning this part of the document, Mr. Kahlie recalls that Webber asked for an update with regard to the State. Mr. Kahlie said he made it clear to Webber that, as to issue of compliance, they were "not yet fully in compliance," and that there were inroads being made and the relationship with the State was good. Mr. Kahlie said with regard to the quoted language above that, "In any event, what you see there is a true statement, carefully worded though it is. It's Mr. Webber's wording." At the all-hands meeting, there was no specific discussion about whether the language was misleading. Webber had asked what the nature of the situation was with regard to the State. Mr. Kahlie clarified to Mr. Schachter that compliance has always been an issue, from every offering

document from 1993 onward, and that the language is always "scrupulously accurate in so far as it goes, but never comes out and says the City is in compliance." He said that there "may have been" discussion about whether the offering document should disclose that the City was not in compliance, but in the end, "the language is what it is."

After a lunch break, the interview reconvened.

Mr. Kahlie was shown Exhibit 21 (DK 8859-60), a wastewater system interested parties list dated December 7, 1998. The list does not help refresh Mr. Kahlie's recollection as to who attended the all-hands meeting in which the disclosure language quoted above was discussed. Mr. Kahlie thinks that Salt may have been there, but not Mittelstadt, because she never came to those kinds of meetings. He thinks the meeting took place in the seventh floor of the City Administration Building and that at the meeting, when they got to this page of disclosure, he recalls Webber asking for an update as to where things stood. From there, he recalls a conversation lasting about 15 to 20 minutes in which the status of things was explained to him, including the fact that the City was not yet in compliance. He recalls explaining to Webber that the COSS work had been done, and he also recalls explaining to Webber about the ramifications of the City's not being in compliance, in the event that the State chose to make an issue of it. Mr. Kahlie stated that this description of the meeting was "pretty much the extent of it." Regarding Webber's request for an update on where things stood, Mr. Kahlie explained to Mr. Schachter that the City was not in compliance when it did the last deal, and that Webber had worked on all of the offering documents since 1993, so he had continuity. Mr. Kahlie said that even though he had not been present for the 1997 discussion, he knew that Webber knew the City was not in compliance, and Mr. Kahlie knew that based on his reading of the offering document. He also thinks it is possible that he and Webber may have discussed the compliance issue prior to that all-hands meeting, or that Webber may have indicated to Mr. Kahlie prior to that meeting that he understood at the time of the last transaction that the City was not in compliance. Mr. Kahlie recalls that those who were present for the discussion of the status update at the all hands meeting included Webber, Mr. Kahlie, Hanley, DeRose, Adachi, and maybe Kelly Salt.

Mr. Kahlie then described the meeting with Webber again to Mr. Schachter, attempting to add greater particularity. He stated that during this meeting, he explained that the rate structure was not in compliance, that a COSS had been done, and that the State was aware it had been done. He does not recall whether he said anything about whether the COSS was implemented, but Mr. Kahlie reasoned that had it been implemented, they would have been in compliance, and he told the group that they were not in compliance. He does not recall there being any discussion about why the City had not come into compliance. His discussion of the ramifications should the City not come into compliance was that the contract provisions provided that, in the event of non-compliance, the State could demand repayment of the grants and could accelerate the SRF loans. He also recalls stating that it was his (Mr. Kahlie's) belief that if the State reached the point where it "drew the line in the sand," the Council would act to comply. Mr. Kahlie recalls that Webber's response was that he was ruminating or making notes. He thinks Webber asked whether it was fair to say that no grants or loans have been refused because of the City's failure to adopt a compliant rate structure, and Mr. Kahlie answered that to his knowledge, none had been. He does not recall a discussion as to whether the City's lack of compliance should be disclosed, and he characterized his experience with Webber as, if Webber

felt strongly about anything, then it went in the disclosures. Mr. Kahlie said that, at the time, Mr. Kahlie certainly would not have objected to putting in a disclosure. In response to Mr. Schachter's question, why not disclose the City's non-compliance, Mr. Kahlie responded that it was a good question, and one for Webber, not him. Mr. Kahlie thought that Webber seemed to be satisfied with Mr. Kahlie's explanation that Mr. Kahlie had been in contact with State board staff, and that the State board had not raised concerns about the issue. Mr. Kahlie said these facts were all true at the time, and he thinks Webber drew his conclusions from them. Mr. Kahlie does not recall anyone voicing the opinion that the lack of compliance should be disclosed. In fact, as Mr. Kahlie recalls, Mr. Webber did not take the position that the City was out of compliance, nor did he take the position that the City was in compliance. He was somewhat on the fence in that regard. Mr. Kahlie emphasized that Webber was free to change the language if he felt it should be changed, and that Mr. Kahlie's obligation was to lay out for Webber the situation and the risk of what could occur if the State put its foot down. Mr. Kahlie stated that, in the end, when the State did put its foot down, the Council did exactly what Mr. Kahlie thought they would.

Regarding who else may have attended the meeting, Mr. Kahlie said that he did not think that Ed Ryan participated, Terri Webster did not usually come to them, and he did not think Frazier or Vattimo was there. He said that there was more active participation in the "Pat and Ed level" with some of the earlier issuances, but that had begun to taper off by that time. Mr. Kahlie had been involved in the 1998 water issuance, and Ed and Pat participated in more of the all-hands meeting drills in that one than they did in later ones. He thinks the reason was that they began to develop a comfort level.

Moving through specific disclosures contained within the 1999 offering (Exhibit 20), Mr. Kahlie said the following:

- Regarding the sentence that "the City believes it is in compliance with all laws" (COS 005905), Mr. Kahlie believes that sentence relates to the preceding paragraph and not specifically to the issue of the rate structure. He believes this sentence reflects Webber's analysis based on his reading of the materials provided to him by Bromfield regarding compliance with Clean Water legislation. Mr. Kahlie recalls that Webber asked Bromfield whether Bromfield believed the City was in compliance with all laws (or whether the statement, as it read, was correct), and Bromfield responded affirmatively, and therefore that is what was put in the disclosure. Mr. Kahlie thinks that Bromfield was present for part of the all hands meeting, in that he would come in to discuss disclosure related to limited issues. As Mr. Kahlie interprets that sentence, he thinks it is "not entirely accurate." Mr. Kahlie said that Bromfield was the lead attorney on wastewater related litigation. He believes Bromfield was aware that the COSS was not implemented. Mr. Kahlie does not recall having specific conversations with him about it, but that does not mean Bromfield did not know.
- Mr. Kahlie stated that he would not characterize the term "strength" of sewage as a term of art. It meant such things as TSS, BOD, and COD.

- Mr. Kahlie said that the sentence regarding rates being reviewed annually (COS 005904) was accurate. He said they are reviewed at least that much, as part of the rate analysis function.
- Under the heading “Wastewater System Financial Operations” (COS 005914), he said that they (apparently meaning financing services) would have been responsible for preparing or ensuring the accuracy of the statements in that section, and part might come from the wastewater staff. Mr. Kahlie reviewed the first two sentences of the fourth paragraph: “Sewer service charges are based on the characteristics (volume of sewage, or flow, and suspended solids, or strength) of the wastewater discharged by each particular sewer user. All sewer users are charged based upon the amount of flow and solids which they discharge into the wastewater.” He said he believes this was accurate at the time it was made.
- Regarding the Prop 218 disclosures (COS 005919-21), Mr. Kahlie said it was always problematic as to whether Prop 218 applied to sewer rates, and that the case law “flip flops” on that issue. Mr. Kahlie said there was always a discussion on current status of Prop 218 case law and whether it was applicable to sewer rates. He recalls that there were questions about whether the Prop 218 discussion needed to be so extensive, and whether it could be crafted in a more straightforward or understandable way. Mr. Kahlie said that Webber wanted it the way it appears in the document. Mr. Schachter asked why they made such a lengthy disclosure on the Prop 218 issue, and none on the issue of compliance of the user rate structure, and Mr. Kahlie could only guess that Webber thought that exposure on Prop 218 was more significant and of greater concern than the issue of State board compliance.
- Mr. Kahlie does not recall any discussion of whether the potential need to repay loans should be shown as a liability.

Switching gears to the wastewater department’s annual financials, Mr. Kahlie said that they are prepared by the Auditor and Comptroller, and that he has no role in preparing them. He never participated in discussions concerning whether the City’s lack of compliance should be disclosed in the financials, nor did he ever hear of such discussions taking place. Nor does he recall any discussion with anyone about whether disclosure of the non-compliance of the sewer rate system would be of significance to any rating agencies.

Exhibit 22 (COS 003576), dated September 17, 1999, is a memo to Mr. Kahlie from Hanley regarding “SRF Loan Document Issues.” It appears from the memo that it is a response to a memo from Mr. Kahlie, dated 9/7/99, which Mr. Kahlie was not shown during the interview. Mr. Kahlie does not recall Exhibit 21, and does not know why he would have asked for this, but he said it seems to be responses to questions regarding the SRF loan program. Mr. Iredale identified that sentence one of the memo states that “the following responses are provided to Mantague De Rose and Associates’ comments.” Mr. Kahlie said that Montague was the

financial adviser then and still is. He guessed that this document was prepared in connection to unrelated revisions to SRF loan documents. Regarding point D at COS 003577, the memo states that "the Division of Clean Water Programs of the Board has approved draft revenue programs for both of the following Projects..." Mr. Kahlie thinks this is an issue in connection with the approval of loans. He has seen SRF loan documents stating that the State has seen, reviewed and approved a revenue plan. Mr. Kahlie does not know what the State reviewed, since he did not give it to them, and he does not know what a draft revenue program is in this context.

Exhibit 23 (DK 9913) is a July 13, 1999 "Discussion Summary." Mr. Kahlie identified this as something that "looks like his work," and he thinks he probably drafted it because someone asked him to. In light of its title, he thinks the intent was to talk to someone about it, but he is not sure who. His best guess is that it could have been for a discussion with Mayor Golding, and he does recall discussing the underlying issues with her. He thinks the people that attended that meeting were Mr. Kahlie, Loveland, the Mayor, and a staff person in the Mayor's office (though he does not recall who). The purpose of the meeting (leaving aside Exhibit 22, since it may be unrelated), was that during the timeframe that the Pinnacle study was completed and "put on the shelf," a staff member in Councilmember Kehoe's office, Craig Adams, got a hold of the study and made some erroneous conclusions with regard to something he read in it. On his faulty understanding, Adams told Kehoe that, if implemented, the study would dramatically decrease single family user rates. Kehoe wanted to discuss this in open session. She approached the Mayor and the Mayor resisted, and then the Mayor asked for a briefing on the issue from the staff. Mr. Kahlie can remember briefing the Mayor on many, if not all of the issues, that are contained in Exhibit 22, but he cannot say for certain that that was his purpose for creating the document.

He recalls that Kehoe "would not let go of the issue," and that the Mayor did not want to have a discussion about it. The Mayor said that they would do a new study with a stakeholders group, as a compromise. As a result, the direction was given to the Manager to do a new COSS for both water and sewer. This direction resulted in what Mr. Kahlie refers to as "Black & Veatch 1," which began in the 1999 to 2000 timeframe in conjunction with a stakeholder group of Mayoral appointees, including Kelco representatives. At that meeting, Mr. Kahlie recalls telling the Mayor that the City was not in compliance with the rate structures, and that the consequences were that the State could call the loans. Mr. Kahlie recalls the Mayor asking him whether the State was demanding that the City "do it now," and his answer to her was truthfully, "No, they are not." In response to why a new study needed to be done, Mr. Kahlie said that by the time this meeting took place, Pinnacle 1 was dated 1998 but was based on information from 1996. Mr. Kahlie warned that data gets "stale," and if a study is being done for a forward looking test year, you would want current information. The rationale is that things evolve, for example, the nature of capital programs, and studies look forward to 4-6 years in the future. For these reasons, it is important to have the most current information available, to replicate reality as closely as possible. Mr. Kahlie recognized that the end result of the study would not change with regard to the COD requirement. What would change would be the costs to be shared by customer classes, and the change would be significant enough that a COSS should not be based on stale data.

Mr. Kahlie was then shown a series of emails to refresh his recollection and contextualize the next set of questions:

- Exhibit 24 (COS 000005), email from Mr. Kahlie to CSP Manager. GIL, dated 11/3/99, re: "Meeting with Chris Kehoe Nov 2 Re Cost of Services Study - forwarded"
- Exhibit 25 (COS 00023), email from Adachi to CCP manager dated 10/14/99;
- Exhibit 26 (DK 09920), an email from Schlesinger to Loveland and Gardner, cc: Mr. Kahlie and others, dated 10/19/99, re: "Water and Sewer Cost of Service Studies"
- Exhibit 27 (DK 09921), email from Christine Reuss to mev, dkk, dated 10/20/99, "re: Sewer Cost of Service Study"
- Exhibit 28 (DK 09919), email from Christine Reuss to dkk, dated 10/20/99, re: "COS Studies"
- Exhibit 29 (no bates), email from Mr. Kahlie to CCP Manager, dated 10/27/99, re: "10/28 Stakeholder's meeting cancelled"
- Exhibit 30 (DK 09922), memo (undated), entitled "Sewer/Water Cost of Service Study"
- Exhibit 31 (COS 005529), email from Schlesinger to Loveland, dated 11/1/99 re: "Grand Jury Review of Sewer Rates"

Upon reviewing these documents, Mr. Kahlie stated that looking at them increases the likelihood that the July 1999 document (Exhibit 22) was created for the purpose of briefing Mayor Golding. He thinks he may have provided the document to others in advance or in connection with the meeting with Golding, assuming it was used at all. That document is the type of thing he usually puts together for purposes of a meeting or for going up to Council.

Exhibit 32 (COS 000118) is a memo dated October 6, 1999, from Loveland to the Mayor and City Council, transmitting the Pinnacle 1 study. Mr. Kahlie's initials on the memo ("DHK") indicate to him that he prepared it. Upon seeing the document, Mr. Kahlie asked, "Have you ever prepared anything you didn't agree with for somebody higher ranking than you?" He elaborated that it was most likely Loveland that asked him to prepare it. The memo states: "Our conclusion, based on the studies and extensive internal review, was and is that the water and sewer rate structures adopted by the Council are both business-friendly and consistent with the requirements of Proposition 218. This being the case, no changes are needed or recommended at this time." Mr. Kahlie said that he was directed to prepare a transmittal memo incorporating the quoted sentence, and that he "saluted smartly and charged up the hill." Mr. Kahlie does not recall specifically what Loveland told him to do, but Mr. Kahlie knows that he prepared a memo to accomplish what it was that Loveland wanted to do. Mr. Kahlie recalls that Loveland was transmitting the document at this point in time because it was "smoked out by

Kehoe's underling. Otherwise that thing wouldn't have gone anywhere." In connection with transmitting the COSS to Council, Loveland wanted to include a cover memo stating they were not making any recommendation for any changes. Mr. Kahlie recalls that Loveland wanted to characterize the issue as relating to Prop 218, so that is how it was done. According to Mr. Kahlie, the language of the memo made sense, but did not necessarily address whether the City was in compliance with State requirements. Mr. Kahlie does not recall Loveland expressing why he wanted to tell the Mayor and City Council that no changes were recommended at that time, though Mr. Kahlie added that Loveland would not have needed to tell him since he knew the answer already from the earlier Conrad meeting.

Mr. Schachter asked why the City Manager would want to please Kelco and not change the sewer rate structure, and Mr. Kahlie speculated that the City Manager would not be particularly concerned about whether this had an impact on Kelco or not, though the elected officials would be. Mr. Kahlie pondered aloud why elected officials who typically benefit from doing things for the single families (where the votes are) chose in this instance not to, and instead chose to continue to take care of "one big nasty discharging company." That said, Mr. Kahlie said that Mayor Golding was very supportive of big business in all of its forms. There was a recession at the time, and the City wanted to do things supportive of big business. As discussed earlier, for example, Mr. Kahlie saw the changes in water capacity charges as an arbitrary and capricious change in favor of industry, based on nothing more than the Mayor picking a number that she liked.

Exhibit 33 (COS 005530) is an email from Schlesinger to Myrna Zembrano, dated 10/20/99. Mr. Kahlie identified that Larry Gardner was at that time the Water Director and is now General Services Director, Zembrano (as identified in a previous exhibit) was a member of Kehoe's staff, the reference in the email to "Pat" is a reference to Pat Frazier, and Christine Reuss reported to Mr. Kahlie. The email relates that Reuss referred Zembrano to Frazier for an explanation of why the COSS had not been distributed earlier. Mr. Kahlie thought Frazier would have been aware of why the study was "being cut loose then," rather than at the time it was done. He had "probably" discussed the COSS with Frazier, since Frazier was his superior, in charge of Financing Services. She would have been made aware "in a general sense" of the outcomes of the study, and he thinks that as of that date, he had "probably" had conversations with her about the City being out of compliance. The email was also sent to Vattimo, and Mr. Kahlie recalls having conversations with Vattimo about the City being out of compliance. Specifically, he recalls her asking why they were out of compliance, and why the City did not do something to address the problem, and his response to her related to Kelco. Mr. Kahlie said that Vattimo had been "bothered" by that justification and told him so.

Looking back at Exhibit 28, Mr. Kahlie's attention was drawn to the portion of the email stating that Frazier said that "the reports did not justify changing the rate structure and since we did not have a recommendation to change anything we were using them to simply justify our existing structure." Mr. Kahlie said he did not think Frazier would have said that the report did not justify changing the rate structure, and he was never in a meeting or conversation where he heard her say it. Nor does he think he ever had any conversation with Frazier about the position in the email, and how it is contradicted by the report itself. The focus then turned to Exhibit 28. Mr. Kahlie identified Patty Krebs as the front person for a group called the Industrial Environmental Association, a trade group made up of representatives from Kelco and other

industry, none of whom were "keen" on an organics component in sewer rates. Mr. Kahlie thinks the purpose of the scheduled stakeholder's meeting was probably to discuss the sewer COSS. He does not recall whether the timing of this was before Mayor Golding directed a new COSS. He thinks it would have been after they were given to understand that the Manager was not recommending any changes to the existing structure. Exhibit 29 was sent to Frazier and Loveland with copies to Schlesinger, Vattimo, Hanley and someone in the City Attorney's Office (the "CAO"). In the last paragraph of the email, Mr. Kahlie referenced the final revenue plan as a "condition precedent" to the release of funds beyond the 90% level. He explained that meant that the SRF contracts have provisions that require that certain things be done in order to get the last percent of the fund commitment. He was raising the issue that MWWD had one or more loans in process that they were drawing against, and at the point that they would hit the 90% draw level, if people at the State board were paying attention, the board might ask for a final revenue plan, and at that point the non-compliant rate structure might be a problem.

With regard to Exhibit 24, the 11/3/99 email from Mr. Kahlie, the line stating that "Mike committed to an update of the study, to include the extra steps of exploring rate design alternatives and making the end product more user friendly. . .", the reference to "Mike" is Uberagua, then-City Manager. Mr. Kahlie recalls that Uberagua went with him to visit Kehoe (and probably a Kehoe aide) to talk about the 1998 Pinnacle study. Mr. Kahlie recalls that the Mayor wanted to do a new study, and that she wanted to include a stakeholder group as a component of it. It is possible (based on the reference to "Dave" in the email) that Schlesinger attended that meeting as well, but Mr. Kahlie does not recall. He thinks he probably prepared the attached discussion outline, dated 11/1/99, and while he does not specifically recall, he could have given a copy of it to a number of people, and/or he could have used it at the meeting with Kehoe. Nor does he recall why the document was prepared, though he supposes that it could have been for the meeting with Kehoe. At COS 00000007, the second bullet states that, "Staff has advised the Council of the need to comply with various State/federal grant/loan requirements with respect to the setting of sewer rates on a number occasions since first accepting grant funding under the Clean Water Act in the 1970's." There is a reference to "Attachments," which may have been City Manager's Reports that made reference to Council's obligations. The compliance point was made at various times, but the point was not the primary focus or reason for presenting to Council.

Focusing on Exhibit 30, entitled "Sewer/Water COSS," Mr. Kahlie does not know whether or not he prepared it, and does not recall for sure whether he has seen it before today. He thinks it may relate to the email from Kehoe's office asking lots of questions, to which this may have been a response. Regarding the water COSS, he does not recall whether it called for changes, and if it did, whether those changes were implemented. He does recall that neither the sewer or water studies were released prior to 1999, which leads him to believe nothing happened with water. Exhibit 30 (COS 00529), the email from Schlesinger to Loveland, cc: Mr. Kahlie and others, refers to a grand jury review of sewer rates. Mr. Iredale explained that in San Diego, there is a grand jury that looks into investigative issues in the public interest and then issues reports from time to time. Mr. Kahlie does not recall offhand whether a grand jury did look into the sewer rate structure. Next Mr. Kahlie was shown Exhibit 34 (Lateral #2, Box #1, Mr. Kahlie SRF #2 0010), an Oct 5, 1999 fax from Jenna Magan of Orrick Herrington to Mr. Kahlie, attaching a marked up SRF. Mr. Kahlie does not specifically recall receiving the document but thinks he probably did. On page 3, regarding the "Dedicated Source of Revenue," the

handwritten comment is, "Should SWRCB acknowledge that City has already done this?" Of this question, Mr. Kahlie said what was really being asked was whether there was a designated source of revenue for repayment, and the answer would most likely have been that there was, "the sewer revenue fund."

Exhibit 35, a Nov. 16, 1999 fax containing a post-it from Salt to Mr. Kahlie is a "draft" memo re: "Sewer Service Fees and Proposition 218" from Bromfield to Kehoe. Mr. Kahlie said this memo was a response from the CAO to a question posed to it by Kehoe. Mr. Kahlie read it when he received it but does not recall whether he discussed it with anyone. He thought he was receiving it at the time because he "might find it interesting." As to whether it details disproportionate charges between different classes of users, Mr. Kahlie said that according to the CAO the answer was that it did not. If you were to ask Mr. Kahlie, his answer is that it depends on what you look at and what your standard is. Mr. Kahlie described that there are two standards of proportionality, the first being the one in Prop 218, and the second being the State board requirements. Each standard requires a "proportional allocation of costs for a service provided." However, Prop 218 is silent as to how one goes about achieving that proportionality. Prop 218 does not tell you how to implement that standard in order to satisfy the law. In contrast, the contractual obligation of the City to adopt a compliant rate structure under the State's requirement tells the City exactly what to do to satisfy those requirements. In response to whether Mr. Kahlie saw the memo as an attempt to confuse Kehoe, he responded that he saw it as an attempt by Bromfield to respond to the narrow question of whether the rate structure was consistent with the requirements of Prop 218. Mr. Kahlie thinks that is how Bromfield interpreted the question, and there is no standard under Prop 218 governing how to achieve proportionality. Therefore, Bromfield was expressing his view that a structure based on flow and solids could satisfy that proportionality. Mr. Kahlie does not think Salt drafted the memo for Bromfield.

Regarding completion of a COSS, if Mr. Kahlie had been asked in February of 2000 how long he thought the COSS would take to complete, he theoretically would have thought it would be completed by October 2000 (as written in the proposal). There were delays, however, in that the Mayor and staff did not provide a list of stakeholders for the group until July 2000, even though staff kept pestering them for it. The goal with the stakeholder's group was to have it understand the various phases of the COSS.

Exhibit 36 (EA 00828) is an email from Mr. Kahlie to pardiwalas@bv.com and others, dated Oct 2, 2000, entitled "Comments re Karen Keese's email." Mr. Kahlie's purpose in writing this email was that Keese was a consultant who consults to perform COSS's, and she was named to the stakeholder's group for Black & Veatch 1. He thinks Keese probably posed some questions to him. Under "Conclusions" at number 1, Mr. Kahlie wrote, "Blair is confused about what was included in the revenue plans submitted by the City and the PA's. . ." Mr. Kahlie thinks this statement was a reference to Blair's faulty understanding that at the time the City adopted the COD component for PA's, the same structure was also applied to residential or municipal customers. In response to Mr. Schachter's question why, if Mr. Kahlie had discussed this issue with Blair in 1998, Mr. Kahlie was still saying Blair was confused, Mr. Kahlie acknowledged that he might be mistaken as to when he spoke to Blair about setting him straight, and that this email seems to indicate that the possibility exists that it was later than 1998. Mr. Kahlie said that as they moved along through Black & Veatch 1, they would communicate with

Blair to ensure that the end result of the study would be agreeable to Blair. He would refer questions to Blair that pertained to the approvability of a particular approach of cost allocation.

Exhibit 37 (SWRCB 1222) is the final Stakeholders Report (September 14, 2000-May 3, 2001). Referring to its conclusions on page 9 (SWRCB 1232), Mr. Kahlie said that the stakeholders were never able to reach a definitive conclusion on the issue of cost allocation methodology, though they did make some recommendations for changes. The inability of the stakeholders to reach agreement on the allocation issue was, as perceived by Mr. Kahlie, largely as a result of intensive efforts to "misinform or spook" some of the other members, on the part of David McKinley, a Kelco representative. Mr. Kahlie said that there was also a Kelco paid representative, Doug Sain, who was not a member of the stakeholder's group but who appeared at the meetings and "schmoozed" the other members during breaks. McKinley's efforts were focused on discrediting the cost allocation methodology that Black & Veatch was using and that had been approved by the State. As a result, there was a good deal of disagreement among the stakeholders as to Black & Veatch's methodology. Kelco favored a number of different methods with regard to organics that Mr. Kahlie said the State would not approve.

Exhibit 38 (DK 05135) is a June 22, 2001 letter from Blair to Mr. Kahlie. At point 1, Blair refers to the City's current user charge system. Mr. Kahlie said that by this time, Blair would have seen the proposed cost allocation approach that Black & Veatch developed for this study, so that if there were any problems with it, he could let them know. Regarding the substance of the letter, the City had been presenting the functional design allocation in a series of meetings, and the Kelco people opposed it, claiming it was "unfair" since the advanced primary treatment plant at Point Loma was primary by design. The response to Kelco's assertion was that, while by design Point Loma was not intended to treat organics, by function it does, and the permit demands removal of a substantial portion of the organics load. Kelco's argument was that, according to the *permit requirements*, a significant portion of the organics would need to be taken out anyway to meet the SS requirements. The City's position was that the costs for the removal should be proportionately shared. In essence, according to Mr. Kahlie, Kelco's argument was that they should get the organics removal for free, and they should only pay for the incremental amount that removed organics by the special process of chemical augmentation. The City consistently rejected that argument, responding that Kelco should not get to ride the coattails of the SS dischargers for free, and that the City should use the same approach for its retail customers that it used for the PA's. Kelco disagreed, but the City could not justify using a different approach with the PA's than with its own retail customers. Kelco came up with a method referred to as the straight TSS method, which was rooted in putting most of the cost for organics removals on SS dischargers. Mr. Kahlie told Kelco that the State would not approve this methodology, and then Mr. Kahlie sent Kelco's proposed methodologies to the State, hoping that the State's response would quell some of the stakeholder conflict. In this response (Exhibit 37), the State did say Kelco's proposals would not work, and that only the current charge system (referring to the one used by PA's) would be acceptable. As to whether Mr. Kahlie thought it was possible that Blair, when writing this letter, was under the impression that the City itself was currently charging for COD, Mr. Kahlie skeptically said it was "possible," but he thinks Blair just was not a "careful wordsmith." Mr. Kahlie does not recall conversations with Blair at this stage about the City being out of compliance and says that, at this point in the game, why would they be conducting a COSS in the first place? As to whether it was possible that Blair could have thought the study was just a review of cost allocation methodologies, Mr. Kahlie said

"anything is possible," but he thinks that is an unlikely scenario. However, Mr. Kahlie cannot recall a conversation that would contradict that theory either.

Exhibit 39 (COS 007104) is an email from Mr. Kahlie to Vattimo dated October 25, 2001 re: "Closed Session 218 Discussion." In the email Mr. Kahlie states that he needs a policy decision on 218 to finalize the COSS. Mr. Kahlie does not recall specifically what concern he was referencing in this email.

Exhibit 40 (CSD MAI 5800) is a document with the heading "Sewer Rates - Strength-Based Billing" dated 10/25/01. Mr. Kahlie does not recognize it. Exhibit 41 (SP_SEC_SC002577) is an email from Mr. Kahlie to Clifton Williams, dated 11/19/01, re: "Cost of Service Phase-In." Mr. Kahlie identified Clifton Williams as a City employee. He recalls that the conversation with Blair that is referenced in the email was the notion of phasing in the rate increase, in order to mitigate the "pain" on those who would be impacted. He does not know whether the phase in question was posed by Kelco or came from within the City, but he recalls that he asked Blair and the answer was "a succinct 'No.'" Mr. Kahlie said that it seemed "straightforward" to him, based on the conversation referenced in this email, that at the time the State was clear that the City was out of compliance. Exhibit 42 (no bates), dated November 20, 2001, from Mr. Kahlie to Vattimo, "Re: 218 Closed Session Issue," refers to the need for a resolution to the Prop 218 issue and its applicability to sewer rates. Mr. Kahlie said that there are conflicts between Prop 218 and the State board requirements (as described above), and he thinks the Prop 218 issue that needed resolution had to do with the desire of some to institute a "lifeline sewer rate" (i.e., lower rates for low-income people). The issue was that if Prop 218 applied to sewer rates, then lifeline rates would not be permissible. Prop 218's applicability would preclude any kind of low-income or senior citizen discount because a discount to some would force others to pay more. This is the issue that, at his behest, he wanted discussed at closed session. The State board guidelines, in contrast to Prop 218, are permissive with regard to a low-income discount (though not permissive with respect to a senior citizen discount).

Exhibit 43 (no bates) is a "Draft" Sewer Cost Of Service and Rate Design Study, dated November 30, 2001. This is the document that Mr. Kahlie has referred to as "Black & Veatch 1." He thinks that, by this time, for all intents and purposes it was complete. He said it was left as a draft because, "we once again ran afoul of the Kelco issue." As a draft it was never released, meaning that it was once again discussed with management who then appreciated that a rate change would negatively impact Kelco. By then, McKinley and his superiors had been using Sain and others to lobby. He recalls there being a "back and forth" with Black & Veatch on the COSS, and then at some point there was a "final draft" to show management. He thinks (subject to his later clarification) that this is the document that would have gone to management, including Loveland, Frazier, and Schlesinger, if he was still there. He said management arrived at the same place they had been with the Pinnacle study. He recalls that the conversations regarding the Black & Veatch study were essentially similar to those regarding Pinnacle. He says Schlesinger, Loveland, and Frazier would have been the "principal players" with whom he discussed the study. With regard to keeping the study in draft, the conversation was essentially that, because of the impact on Kelco, according to Mr. Kahlie, this study would "join the Pinnacle study on the shelf." He does not recall specific conversations with those people in particular, but he does recall laying out for them who would benefit and who would be disadvantaged if the study were implemented. He said "it came down to Kelco again, and the

direction was essentially not to produce the study in a final form.” He does not specifically recall who gave him that direction but thinks it could have been Loveland or Frazier. He does not recall any specific conversations with them on the subject. Schlesinger would not have stopped the study; it would have to be someone above Schlesinger. Although he does not specifically recall a conversation in which Frazier or Loveland directed him to keep the document in draft, he does remember being told by someone at that level to just “sit on it.” According to Mr. Kahlie, there are a limited number of people that could make that decision, and it had to be someone at the Loveland or Frazier level.

Exhibit 44 (no bates) is a December 6, 2001 memo to Mayor and City Council from City Attorney re: the application of article XIID to Sewer Fees. Mr. Kahlie does not recall who drafted the memo, and thinks it might have been Salt. Under the “Recommendation” at page 1, the recommendation is made to continue complying with Prop 218 because of outstanding debt. Under the “Facts” section at page 2, there is a statement regarding the negative impact certain disclosure could have on the sale of bonds.

Exhibit 45 is a 1/15/02 Black & Veatch report (MWWD - BH0287) that is not marked draft. Compare Exhibit 46, a May 2002 Black & Veatch report (SP_SEC_SC002382) with “draft” stamped on each page. Mr. Kahlie reconsidered the sequence of events concerning finalizing the Black & Veatch studies. He guessed that Exhibit 42 (November 2001) was a “draft” that was given to him, then there was a final version (January 2002). He thinks May 2002 was the one later marked draft and given to Frye because of the public records request to Lamont. Mr. Kahlie thinks he received a direction from the City Manager once Frye requested the document, to supply it but mark it as a draft, even though it was a final. At least in the Exhibit copy of Exhibit 46, the May 2002 study does not have the Black & Veatch transmittal letter either. When he received the January 2002 study, Mr. Kahlie thinks his understanding at the time was that the study was completed. The product would have been sent to management, including Frazier and Loveland (and possibly, but doubtful, Lamont). Mr. Kahlie does not know whether Mendes had joined the City by then, but if so, he would have received it. Schlesinger would also have received it if he were still there, and maybe Uberagua.

Exhibit 47 (DK 05815), an email from Jim Madaffer to Mr. Kahlie, dated 1/29/02, re: COST OF SERVICE MATTER, references Mr. Kahlie’s presentation that day in closed session. Aside from Council members, Mr. Kahlie recalls that Salt was present at the closed session (she made part of the presentation), and Ed Ryan (the Auditor) was there. In looking at the closed session attendance sheet, (Exhibit 48, 1/29/02 attendance sheet, no bates) he can recall some of the listed attendees being there, but not all. In addition to the others mentioned, he also recalled Frazier being there. Prior to the session, he spoke with Salt about it, because they were going to make the presentation. He recalls that she had a memo of law that she was going to provide or read to Council. He thinks he also probably discussed the substance of his and Salt’s closed session presentation in advance with Adachi and Reuss, and maybe Frazier. In terms of duration, he recalls that if the presentation lasted 20 minutes he would be surprised. Of the presentation itself, Mr. Kahlie does not recall whether he led off the issue or Salt did. Her focus was largely on Prop 218, and he spoke to issues on State board compliance. He laid out the City’s obligations as a result of having entered into contracts for grants and loans. He told them that the City’s obligation was the adoption of a compliant rate structure; described that it required proportionate allocation of cost; and told them what the cost centers were. He told

Council that large volume organics dischargers would get a significant rate increase as a result of the change, and that low volume dischargers would pay less. Specifically he told them that they were not in compliance because the rate structure did not include an organics parameter. He does not know if he specifically said that Kelco would be most damaged by a rate change, but he would have said that large organics dischargers would be most impacted. Regarding consequences, he told Council in his presentation that ultimately the State had the right to demand the grant money back and they had the right to accelerate the loans if the City failed to comply. He told them the approximate dollar amounts of the accepted loans and grants, at least as he understood them to be at the time. While he recalls that the focus of Salt's presentation was on Prop 218 issues, he does not recall whether or not she chimed in on the State compliance issue. He does not think the meeting was tape recorded.

As for the City Council's response to his presentation, Mr. Kahlie recalls the Mayor asked if the State was demanding that the City make the change now, and Mr. Kahlie's answer was that they were not currently asking, but would be sooner or later. Mr. Kahlie made the point about the City's contractual obligation, and Madaffer's response was, "Screw it. Let 'em sue us." In addition to telling Council about the possible acceleration and how much money was at stake, and what was necessary to comply, he says that he made it clear that the City had a contractual obligation and that at some point in time they would have to make the change. He recalls the Mayor turning to the attorney (he thinks it was Salt) and asking for an additional review on the issue of whether the City had to do this, and she agreed to do it. Mr. Kahlie notes that, having done the review of the issue, he does not think Salt was ever invited back to present it. He does not specifically have any other recollections about comments made by other Council members or the Mayor, but he does have the general sense that the issue was not well received by Council or the Mayor. He characterized Madaffer as "pretty challenging" in terms of his response, and recalls that there were some other questions, but nothing remarkable. Dahlberg then asked Mr. Kahlie whether there were discussions at the closed session about previous rate studies that showed the City was out of compliance, and Mr. Kahlie responded that there were not, because it was not necessary. Mr. Kahlie said that he "doesn't tell Council what they want to hear," although others might. Dahlberg asked whether there was a sense that the issue had to be kept under wraps, and Mr. Kahlie responded that he did not have that sense.

Mr. Schachter then asked whether there was any discussion in closed session about whether the lack of compliance with the State requirements was something that needed to be disclosed (similar to the Prop 218 disclosure discussion in the Salt memo). Mr. Kahlie stated that he did not recall, and that there might have been. He does not recall Frazier, Mendes, Ryan, Girard, or Loveland saying anything. Council did not give any reason as to why they did not want to change the user rates to Mr. Kahlie. Regarding Exhibit 46, why would Madaffer have copied Uberagua on the email? Mr. Kahlie opined that he may have felt badly for "bashing" Mr. Kahlie. Mr. Kahlie has a vague recollection of speaking to Salt after the closed session, but those conversations were in general terms of "wow, that was a pleasant experience..." As to whether Salt got a hard time at closed session from Council, Mr. Kahlie recalls that "they both took some heat," but that he probably got the worst of it. He recalls that Prop 218 was less of a concern than the notion that the City would have to change their rate structure. He does not recall whether Frye said anything. Mr. Kahlie would only have stayed long enough at closed session to see if Council took action on the issue, and he recalls that the action that was taken was to send the CAO back to study the issue and advise on whether compliance was really

necessary, and to come back and make a report at some point in the future. He thinks the task was undertaken by the CAO, but that the CAO never went back to closed session to discuss the matter. He recalls being told by both Salt and Frazier that there was "no desire that this matter be discussed further."

Exhibit 49 (COS 007246), is a 2/1/02 email from Mr. Kahlie to Vattimo and Frazier re: "Revenue Plan Issues." Exhibit 50 (no bates), is a 2/4/02 reply from Frazier to Exhibit 49. Mr. Kahlie recalls having had a conversation with Hanley, and he said that Exhibit 47 "pretty well summarizes it." He recalls that Hanley came in to talk about a series of new SRF loan applications. Mr. Kahlie sent the email to Vattimo and Frazier because, in his view, sending in loan or grant applications to the State could potentially put the City on the State's radar screen. He described that the applications have a revenue plan requirement so that if the State raised the issue of a compliant rate structure, then the issue of non-compliance could come up. He sent the email to Vattimo and Frazier because they are his direct line superiors. He does not recall any specific conversations with them after sending this email. Exhibit 51 (EA 410) consists of handwritten notes with questions and answers. He said that he did not really recognize the handwriting on the notes.

Subsequent to the closed session meetings, Mr. Kahlie believes he had conversations with Salt about the preparation of the legal opinion that the City Council requested, though he does not recall specifics of those discussions. He thinks they had conversations along the lines of how the memo was coming and whether there was any notion of when it might go to Council. At some point, he learned that Salt was given to understand that the memo was not going up to Council, and he thinks this was probably around the same time he got that sense. He thinks Salt probably shared her view of Council's desire not to comply with the CAO's recommendation, but he does not recall anything specific. Exhibit 52 (CSD/MAI005359) is a memo from Mendes to Frye (cc: Mayor, Councilmembers and others), dated April 18, 2002, re: "Cost-of-Service Reports." The memo is transmitting the 1998 Pinnacle studies. Mr. Kahlie recalls a time when Mendes sent Frye the studies, and recalls Mendes asking him for copies of the two studies (sewer and water), but does not recall having an understanding as to why Frye wanted to see them.

Going back to Exhibit 46, the May 2002 draft Black & Veatch study, he thinks Reuss stamped "draft" on the study and that he (Mr. Kahlie) directed her to do so. He recalls that they were going to distribute the study because Frye demanded to see it. He does not know how the date on this "draft" came to be "May 2002," and he wonders whether maybe this was the point in time when the last outstanding issues with the study had finally been completed.

Exhibit 53 (DK 02578) is a June 24, 2002 document entitled "Draft Scope of Services Water and Sewer Cost of Service Studies and Related Matters." Mr. Kahlie thinks that this document would have been preparatory to conducting the updates to the Black & Veatch study. Mr. Schachter asked why there would have been an update, and Mr. Kahlie said he thought that, on the part of Frye, there was a desire to move forward with a discussion and implementation of it. Mr. Kahlie explained that in May or June 2002, they had gone to Council and discussed the possibility of a water rate increase. Frye, having already seen the COSS, said that if they were to do rate increases, then she wanted a COSS done. Her primary interest at that point was a concern that developer fees were not fully cost recoverable, and Frye wanted to

assure that they were. In essence, this COSS was done as a “quid pro quo” on water rate increases in May or June 2002: Frye voted for rate increases and in exchange the manager moved to update the two studies. This was done in open session. He recalls that there was once again the “stale data problem” with the May 2002 “draft” version of the COSS. He recalls explaining to Frazier, Loveland and Mendes that information in the Black & Veatch study was again stale, since the prior year constituted the first year of test data. For a study to be of value it must include data for the *future* fiscal year. The previous Black & Veatch study, commenced in 2000, used data from 1998 and 1999. He discussed the issue with Black & Veatch and they concurred that an update was necessary. Rather than doing two brand new studies they decided to update the ones that were done already.

Exhibit 54 is a composite Exhibit containing the October 31, 2002 (draft) (COS 003547) and the final Salt memo, dated November 14, 2002 (No bates). He thinks Salt drafted the memo and acknowledges that he may have commented on it or contributed to some of the substance. He does not know why it was issued from Salt and Vattimo. He does not recall any specific conversations with Salt about the memo, and does not recall her ever telling Mr. Kahlie that she thought the City was in compliance with the State requirements. He believes Salt said she thought the City was not in compliance, but does not recall any specific conversations on that subject. He recalls conversations with her in which they discussed the consequences of the City being out of compliance, and recalls telling her that he thought that the State could accelerate loans and demand repayment, and Salt did not disagree with him. She never said to him that she did not think the City was really out of compliance until the State said they would terminate the contract or follow the noticing provisions.

Exhibit 55 (DK 05347) is an email from Mr. Kahlie to Frazier dated 11/7/02, “Re: SRF Memo Final.” He thinks Salt (in the bottom string, stating “attached is the revised draft closed session memo”) is referencing the Oct 31, 2002 draft of her memo. In the top string of the email, Frazier asked Mr. Kahlie for a bullet point summary including “what we have done over time, with some of the rationale, ...what is at risk.” Mr. Kahlie thinks it was probably in response to Frazier’s request that he created the Salient Points document. He had recently looked at the document electronically and noted its title was something to the effect of “Mayoral Briefing.” However, he does not know whether the memo was ever presented to the Mayor, and his intent was simply to provide Frazier with something she asked for.

Referring back to Exhibit 10, the Salient Points document, he thinks the dollar numbers referenced therein may have changed slightly but that the document is otherwise accurate. He does not recall discussing the document with anyone, nor does he recall anyone contacting him to express disagreement about anything in the document. He does not think he briefed the Mayor using this document, or that he went to the Mayor’s office to discuss it. In looking at Exhibit 56 (no bates), the memo dated November 14, 2002 from the City Attorney to the City Clerk, re: “Closed Session Agenda Items for November 19, 2002,” Mr. Kahlie was asked whether the compliance issue was placed on agenda for closed session, and he stated he could not recall, and that the CAO, not he, would have been responsible for that. With regard to the final Salt memo (Exhibit 54), he learned from either Salt, Vattimo or Frazier that the memo would not be taken up to City Council, but he thinks the memo was still circulated to them. As of November 2002, after the decision not to take the matter up to Council, he recalls a conversation with Salt about the decision. He described the decision as “not earthshaking to

him,” since it was clear this was not something the Council wanted to deal with. In his conversation with Salt he thinks she said something about having been told the memo would not go up, and his response was something to the effect that the decision was “not surprising.”

Exhibit 57, a November 22, 2002 memo from Lamont Ewell to the Mayor and City Council, re: “Transmittal of Draft Sewer Cost of Service Study” was prepared by Mr. Kahlie at Lamont’s instruction. He thinks the memo was prepared when Frye threatened the Public Notice Act request, and that this was probably the first time the COSS was distributed to Council. He realized from seeing this document that, contrary to what he stated earlier, it was probably at this time (not in May) that he directed Reuss to stamp the COSS “draft” for circulation to Council. From January 2002 to November 2002, he presumes the “drafts” are the same, but there may be minor changes. The language of Exhibit 53 states that “the document is not in final form.” As to whether this was a true statement, Mr. Kahlie responded that as far as Black & Veatch was concerned, they thought it was final. All Mr. Kahlie knew was that Ewell wanted the document kept in draft, though he did not share with Mr. Kahlie the reason.

Exhibit 58 is a one page sheet (no bates, no date) that states at the top “Closed session.” Mr. Kahlie does not recall seeing it before and thinks it looks like Salt may have prepared it. Exhibit 59 (COS 5562), is an email from Mr. Kahlie to Hanley, Katz, Mendes, and Tulloch, dated 3/6/03, “re: COSS questions.” Mr. Kahlie explained that “NRC” stood for Natural Resources and Culture, and is one of Council’s standing committees. Exhibit 60 (EA 1785 - 86) is a memo dated March 6, 2003 from the “Utilities Finance Administrator” to “Head Public Works Deputy City Attorney Keri Katz.” He thinks the document looks like something he prepared. Among other things, the memo states that the sewer COSS is scheduled for completion during the week of July 21st, 2003.

Regarding the proposed sewer revenue bond issuance in 2003, Mr. Kahlie describes his role as the “usual” role in providing coordination and input where necessary, in the same way he did with the 1999 offering. Looking at the 2003 draft POS (COS 6959 at 6989), dated June 20, 2003, Mr. Kahlie said the language that no funds had been “disallowed” looked the same to him as the earlier language. He says that he participated in this language being included in the draft offering statement, and that the participants were essentially the same parties that participated in the 1999 offering, including Mr. Kahlie, Hanley, DeRose, Adachi, and Webber (whom he referred to as the “same core group.”) He recalls that once again they discussed the status of the situation with the State, which, as of then, was that they had completed Black & Veatch 1, and were embarking on Black & Veatch 2. He recalls stating that the relationship with the State was still good at that point, and that the State was aware of the work being done. He does not recall whether Salt was at this meeting or the earlier one in 1999. She was there for at least some of the all-hands meetings. He said he had conversations with Webber in connection with preparing the draft OS about the potential consequences of the City’s lack of compliance. Webber asked what the total exposure might be and Mr. Kahlie gave him the “best number he had at that time,” which he thinks was probably more than \$300 million. In response, Mr. Kahlie says that Webber did not say “a great deal.” He recalls that part of that discussion concerned the fact that the State was not making a demand for compliance and that from Mr. Kahlie’s view, at the time the State would ask for or demand compliance, he believed that the City would comply. By the City “demanding” compliance, Mr. Kahlie was referring to a “line in the sand” letter from the State, demanding compliance by a date certain. Mr. Kahlie

recalls that they did not get such a letter until the early months in 2004. He does not recall Webber or anyone else saying that disclosure was not necessary until the State threatens to sue. Nor can he recall any discussion about the pros and cons of making disclosure in June 2003 about the City's lack of compliance. Mr. Kahlie said that he did not suggest that they should disclose the fact that they were out of compliance. He said he "la[id] out the situation as it then existed," laid out the exposure, and then left it "to the man whose business it was for disclosure issues to make that decision," just as he did for the Prop 218 issues. Mr. Kahlie does not recall Webber saying that disclosure was necessary, and he surmises that had Webber said, for example, that "it needed to be 16 pages long, it would have been." Mr. Kahlie cannot recall anyone at that meeting suggesting that the non-compliance was something that needed to be disclosed.

Omid Yazdi then asked whether anyone else in the room at the all-hands meeting gave their views or any input on Mr. Kahlie's discussion of the City's non-compliance. Mr. Kahlie said there was "nothing of consequence" discussed in that regard. He elaborated that Webber was bond and disclosure counsel so they looked to him to make those disclosure decisions. He said they did not hide anything from him. Mr. Kahlie guesses that maybe Webber agreed with the notion that, at the point the City were to receive the "line in the sand letter" from the State, the City would do what they needed to do (though he does not recall Webber ever saying that).

Exhibit 61 (DK 3396-97), handwritten notes dated 8/14/03 (with "Russ Gold" written at the top), according to Mr. Kahlie, appears to be his own handwriting of notes he took from a meeting. Mr. Kahlie identified Russ Gold as an attorney with Luce Forward. He thinks this meeting was in connection with a discussion of pension lawsuits or pension related issues, and Luce was representing the City in defending one or more of the lawsuits. He does not recall why he participated in this meeting. [At this time KPMG representatives stepped away for a discussion of this document, in case the privilege still attached to the document, and returned once discussion of Exhibit 57 ended.] He thinks the "P" in his notes is a reference to Pat Frazier, and that they were questions she asked, including the exposure of the wastewater system. In reviewing his notes, Mr. Kahlie concluded that this document had nothing to do with the compliance of the rate structure but rather with the Gleason litigation. Exhibit 62 (COS 3032-2003), a letter to Mr. Kahlie from Black & Veatch, dated October 2, 2003, appears to Mr. Kahlie to be a transmittal memo of the updated and "close to final" COSS. Exhibit 63 (COS 3483), an email from Salt to Dan Deaton and Webber at Orrick (cc: Mr. Kahlie), dated 2/13/04 ("SRF MemoFinal_CL_wpd"), attached Salt's 2002 closed session memo. Mr. Schachter asked Mr. Kahlie what happened that led up to the March 2004 disclosure, and Mr. Kahlie described that, starting in November 2003, the City received the so-called "line in the sand" letter from the State. Mr. Kahlie said that, prior to receiving the letter, he had told Blair that unless Blair was prepared to draw the line in the sand, this issue would never be resolved. Mr. Kahlie recalls that the November letter arrived, and then there was a response sent by Loveland to Blair in the early part of January 2004. Mr. Kahlie said that Blair responded to that letter by demanding the City's compliance by July 1, 2004.

Mr. Kahlie said that, as he predicted, once the "line in the sand" letter arrived, despite a lot of Kelco opposition and lobbying, and trips to Sacramento by Kelco people, who went accompanied by a member of the Mayor's staff, the State would not relent and the City

ultimately adopted the compliant structure. The structure that the City adopted differs slightly from the structure contained in Black & Veatch 2, because of post-production accommodations reached with the State board staff as to a particular issue. As for the March Voluntary Disclosure, it was part of the annual disclosure for wastewater in 2004. The disclosure was done in March because once the City received the letters from Blair, Salt and Webber coordinated the drafting of an appropriate disclosure. It was Webber's decision that a disclosure needed to be made at this point. Mr. Kahlie only knows it was Webber's decision indirectly (which he thinks he may have learned from Salt). He does not think there were any discussions with Webber about there not being a need to disclose in light of the fact that the City was going to comply, or at least, he did not participate in any. Since Webber wanted to disclose the issue, Mr. Kahlie had no reason to argue. Mr. Kahlie said he was happy to see them "get to that point in the game."

Exhibit 64 is the March 2004 annual disclosure (COS 003239). Mr. Kahlie does not recall who prepared the language that appears at the top of page 10 regarding efforts to comply over the past 16 years. It may have been based on information that he provided to Salt and Webber, since he recalls answering some questions for them on that subject. He believes it is a factually correct statement. Mr. Kahlie is not sure where the number "16" comes from, but guesses that it could have covered some out-of-compliance periods before the 1991 compliance was achieved. The statement about making several efforts to achieve "Council adoption" does not necessarily mean they actually went to Council several times. Mr. Kahlie's understanding of that statement was that it could be a reference to nothing more than staff requesting the COSS, even if the COSS then did not make it up to Council. He is not sure whether he requested the language with respect to the efforts of City staff for compliance, though he thinks he may have suggested a statement regarding efforts to comply, and Webber may have asked whether over a period of time they had attempted to do it.

Exhibit 65 (COS 3211-12) is a memo entitled "Chronology of Events, Wastewater Rate Structure Compliance Efforts as of April 9, 2004." Mr. Kahlie thinks this document looks like something he prepared. He does not specifically recall why it was prepared, but in response to various questions such as why such a memo would be necessary since disclosure had already been made and the City was working on a compliant rate structure, he suggested that it may have been done in preparation for a meeting with the Mayor to discuss issues with Kelco people. He thinks it was probably Frazier that asked him to prepare it, though he is not certain. Exhibit 66 (COS 4863) is an email from Les Girard to Mr. Kahlie, dated 4/15/04, re: "1/29/02 closed session." The email references "yesterday's" meeting with the Mayor. Mr. Kahlie does not specifically recall what meeting this was, but recalls generally that the staff had two or three meetings with the Mayor's office once the State's "line in the sand" letter had been sent and the City was moving toward compliance. The issue got to Council for a noticed hearing on June 8, 2004, and since notice must be sent 45 days in advance of the hearing, he thinks it would have gone out in mid-April. He thinks a meeting with the Mayor would have still been about "finding a way out of this" since there was still a lot of resistance from Kelco. As for the substance of this email, Mr. Kahlie did not recall a discussion with the Mayor at this time about the January 2002 closed session. As to whether Girard's email appears to Mr. Kahlie to be an attempt on the part of Girard to cover himself, Mr. Kahlie responded that it appears from Mr. Kahlie's email to Girard that the Mayor must have asked Girard whether the City Council was told of this obligation. Mr. Kahlie said he recalls something to that effect, and this email response from Mr. Kahlie is conveying that they had been told. Mr. Kahlie, despite numerous different questions

about the context of this meeting and the circumstances of his writing the follow-up email, does not recall details about either event. At best he could surmise that the Mayor may have asserted that they had not been informed of this obligation before. Mr. Kahlie does not think the exposure of the non-compliance issue got much public attention, and thinks that at this juncture the Mayor was frustrated for having the issue "sprung" on him. Mr. Kahlie does not think the attention during this timeframe to the City's financials was the context for the discussion referenced in Exhibit 61. He thinks the primary issue was still, at this late date, the City's having to adopt a compliant rate structure, and the impact that structure would have on Kelco.

Exhibit 67 (no bates) is a memo entitled "SWRCB Grant/Loan Obligation Disclosure Issue, April 26, 2004." Mr. Kahlie said that this was a document that he prepared pursuant to a request by Vattimo. He recalls that Vattimo approached him and said that Webber was asserting that they had withheld information from him, and that they had been doing so for some time. Vattimo asked him to prepare a document that related to the issue, and this was Mr. Kahlie's response. As to whom Webber was making these comments, Vattimo told Mr. Kahlie she believed he was telling the S.E.C. and Les Girard. In response to what his "reaction" was when Vattimo told Mr. Kahlie of Webber's comments, he said Webber's assertion was false. However, when Mr. Schachter asked Mr. Kahlie whether he put in this memo that he had told Webber that the City was not in compliance, Mr. Kahlie first stated that he could not recall. Mr. Schachter asked him why, in addressing the issue of Webber's knowledge of the City's non-compliance, details would not be included in the memo such as the dates on which Mr. Kahlie told Webber this information and who was present when Webber was told? Mr. Kahlie responded, "That's a good question." He continued, "I don't appear to have said anything about that, but it may not have occurred to me to say it at the time." As to whether there was a reason he would not have said it, for example, related to something he may have been trying to accomplish in writing the document that might explain the absence of such details, Mr. Kahlie responded that, in retrospect, probably not. Mr. Iredale then posed the possibility to Mr. Kahlie whether Exhibit 63 could be Mr. Kahlie's response designed to refute specific assertions Webber made. Mr. Kahlie said that "that was essentially it." In response to whether Mr. Kahlie has any doubts today that he told Webber in 1999 and then again in 2003 about the City's non-compliance, Mr. Kahlie responded, "Absolutely not." Mr. Kahlie relayed that he had been told by John McNally that shortly after McNally came on as outside general disclosure counsel, McNally had a meeting with Webber in which Webber told McNally that Webber had not been told, and that information had been withheld from him. Mr. Kahlie responded to McNally that Mr. Kahlie had been told the same thing by other people, and he guesses he [Mr. Kahlie] probably told McNally "it was bullshit." He may have had discussions with others regarding whether Webber had been informed about the lack of compliance (perhaps Frazier or Vattimo), but he does not recall.

Mr. Schachter then asked Mr. Kahlie whether there was anything else we did not cover that we should know as we complete our work on this issue, and Mr. Kahlie responded that he could not think of anything.

Omid Yazdi then asked Mr. Kahlie whether he ever discussed with anyone that the City was, in fact, compliant because it was engaging in a study to analyze rates. Mr. Kahlie did not recall any such discussions, and added that he did not think he would have bought that argument.

Mr. Kahlie affirmed that he is not aware of anyone in City government doing anything deliberately in violation of the rules. He agreed to have his attorney notify us if anything additional should occur to him that is relevant to the Audit Committee's work. The interview ended by Mr. Schachter thanking Mr. Kahlie for *his time and for staying so late*.

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